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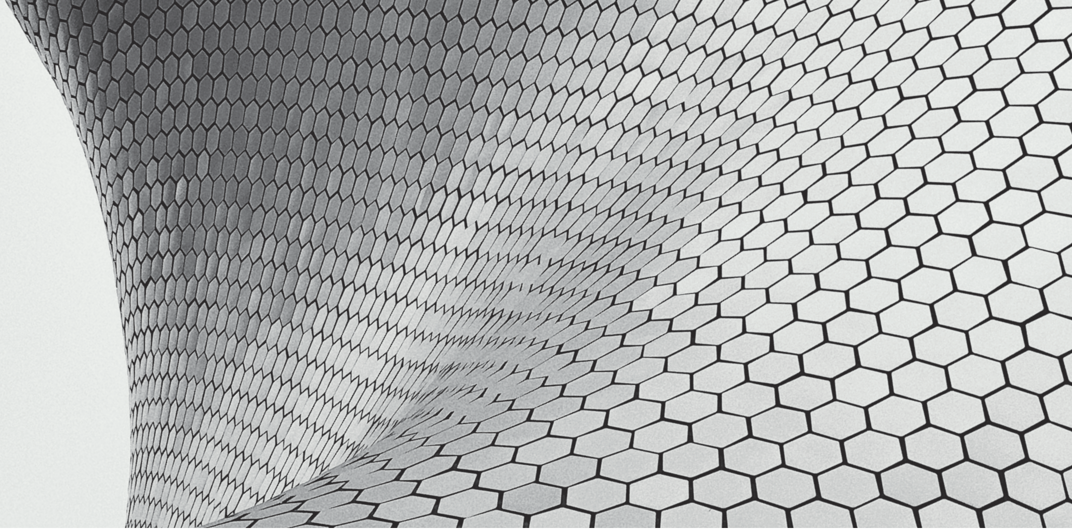

10 Legal and Accounting Considerations for Founders When Forming their First Startup

As you begin this exciting new chapter in your professional journey, you want to give both yourself and your organization the best chance to succeed. The following checklist will act as a guiding light as you navigate these unchartered waters.

1. Team

Determine ownership and responsibilities among the founding team. These are some of the most critical decisions for any startup. Coming together in a new business is like a marriage, and co-founders need to know each other well and be comfortable with one another before they make the commitment. They also should agree on the roles, equity and, while potentially awkward, ideally how to manage the possibility they may separate and go their own ways at some point down the road.

2. Advisors

Choose experienced advisors right away, including lawyers and accountants. Advisors who work with startups and in your particular industry will help avoid pitfalls and facilitate getting the business up and running. In addition, advisors who are willing to defer or forego all or part of their fees can be helpful, but keep in mind you also get what you pay for.

3. Selection of Entity

Choose the right legal entity for your business needs. Consult with your advisors on whether a regular C corporation or a limited liability company, or LLC, is best. In some instances, an S corporation, partnership, or even a sole proprietorship may be the right way to go. Each has their own unique tax, accounting, and governance considerations, and each also has advantages and disadvantages depending on the type of funding needed. For example, venture capital firms don’t like to invest in LLCs because this exposes them directly to losses and gains, given the pass-through tax structure. Having a well-considered entity in place at the beginning is critical. Waiting until the business is up and running is a mistake.

4. Founder Equity

Although sometimes hard to discuss if you have teamed up with friends or others you know well, deciding on the fair allocation of founder equity is critical. And getting the equity doled out to the founders early on, before the business commences (i.e., before significant value has been created) is key. The objective is to get founders their equity for a low price, before the business has any assets or value, so that all value accretion is appreciation and taxed only on exit, and ideally at the lowest of applicable tax rates (e.g., long-term capital gain rates versus ordinary income rates).

5. Vesting and Section 83(b) Elections

Everyone goes into a startup excited and unified in their desire to succeed, but we all know that not every relationship or business can be successful. Planning for how to deal with fellow founders who choose to do something else is one of the best ways to ensure the business succeeds even if the team changes. To do this, all founders (including those who developed the idea for the venture) should jointly agree to subject their equity ownership stakes to vesting, meaning that the business can take back any unvested equity from a founder who leaves the business or is terminated from her position. The vesting can be accomplished in many ways, (e.g., through mandatory buy-back provisions at a nominal price or at fair market value obtained through an independent third party valuation). Within 30 days of any vesting being imposed on founder equity, each founder must make what is called an Internal Revenue Code section 83(b) election where they notify the IRS by certified mail, return receipt requested, that their equity is subject to vesting and that they elect to include the value of it in income at the time such vesting was put in place. The election ensures that their purchase price for their equity equals its tax basis, and that all future gain is taxed as capital gain, and preferably as long-term capital gain, which is subject to preferential tax rates. Without the election, the future appreciation in the equity will be taxed when the stock vests as ordinary income, which is currently taxed at higher rates than long-term capital gain. In addition, if no election is made and there is no liquidity in the stock when it vests, then the founders will have to come out of pocket with funds to pay the taxes due at that time.

6. Funding and Growing the Business

It is often difficult at the beginning of a venture to know what your startup might be worth as you begin to speak with angel investors or even venture capitalists. Many startups put off this discussion by raising capital with convertible promissory notes (CPNs) or simple agreements for future equity (SAFEs). Both of these debt or debt-like instruments are designed to permit the investors to convert their investment into equity at a valuation to be determined in the future when a more significant amount of money or a more experienced investor negotiates a valuation with the founding team. Often these debt or debt-like instruments have what are called valuation caps associated with them, ensuring that the early funders own at least a minimum amount of the company's equity when such later funding occurs.

7. Attracting New Talent

While issuing a CPN or SAFE to fund a startup can put off having to sort through valuation issues, they allow for an immediate infusion of cash which can help to build a team and attract talent by enabling the company to offer salaries. Most early employees, however, also will want equity in the business, often in the form of stock options or restricted stock grants (for more senior personnel). In other words, the equity in the business is used as additional currency to attract experienced personnel and possibly vendors and other service providers who agree to “invest” in the business in lieu of higher salaries or cash payments. But using equity in this way must be carefully considered and structured to avoid creating tax or accounting issues for either the business or the recipients. This prevents the stock from being given out too cheaply, in which case employees or others might be deemed to receive something for a higher value than they are paying for it, causing them to have taxable income. The business itself may be required to withhold taxes on such “cheap stock” if given to its employees.

8. Registering Other States Where the Startup Is Doing Business

Although many startups choose to organize in a state like Delaware which has a very highly-developed system of corporate laws and an efficient administrative system for filing and keeping track of corporate documents, the business itself often operates in various states. While this is typical, many startups forget that they must file a simple form for authority to do business in the states where they operate. Each state has different tax considerations, including payroll, sales, and income tax requirements, and your advisors can help you manage these requirements. Offsetting research and development (R&D) and other state and federal tax credits against payroll taxes in the states in which your business operates is also key since failure to do so cannot easily be fixed at a later point in time.

9. Ownership Versus Control

Many startup founders get hung up on wanting to maintain more than 50% of the equity in their business so that they do not lose control, but this can be shortsighted. One can control a business even if she owns only a small percentage of the business. Stockholder agreements and other contractual arrangements among founders and investors can be employed to ensure that decision making authority is vested in the appropriate persons without regard to actual ownership. It is worth remembering that it is better to own 1% of a billion dollar company than 100% of a small business.

10. The Key Consideration — Is This What You Want to Do With Your Life?

Be thoughtful about the time and energy required to successfully bring a startup to fruition. Are you ready for the full-time commitment that starting a new venture entails? Are you ready for the late hours, the low initial salary, the investors who turn you away without even letting you speak with them, the knocking on the doors of potential customers who don’t think they need your product or service, and the taking on by you of responsibilities in areas you have zero training or experience? And are you and your co-founders ready to share some of your business with investors and others? If you answered yes to all of the above questions, then take a deep breath, make sure you spend time thinking about all of the issues outlined above, and then go take the leap.

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